# Appendix 4.1

## *Department of Revenue's*
## Briefing Paper on Tax Policy and Restructuring the Gas and Electricity Industries

*REVISED FINAL*

## I. Introduction.

A series of federal acts and rules restructured the wholesale gas and electric market and paved the way for states to restructure the retail market. Even though a restructuring of Washington State's retail energy market may or may not happen in the near future, in-state energy businesses and consumers are affected by the changes in the industry occurring outside our state's borders. While the industry is changing, Washington's tax laws remain the same. Tax laws that are non-responsive to industry realities may result in lost revenues to the state and create a competitive disadvantage for in-state businesses. This paper looks at the energy industry, current taxation of that industry, threats to the state's revenue, and emerging tax policy issues.

## II. Why and how the energy industry is changing.

### a) Federal laws and rules

#### i) Electricity industry

1978 - Public Utility Regulatory Policies Act (PURPA). Out of the "energy crisis" of the 1970's came this search for new approaches to power generation. PURPA imposes an obligation upon the traditional vertically integrated utility (power generation, transmission, and distribution owned and operated by the same entity) to purchase power from non-utility power generators at the utility's cost of new power generation. This obligation fostered the rise of the independent power producers.

1992 - Energy Policy Act (the Act). The Act initiated competition in the wholesale market by empowering the Federal Energy Regulatory Commission (FERC) to order utilities to provide access to their transmission systems to wholesale sellers of power. The Act applies to investor-owed and public-owned utilities as well as the Bonneville Power Administration (BPA). (BPA need only comply to the extent the Act is not inconsistent with BPA's other statutory obligations.) The Act specifically prohibits FERC from ordering transmission access for retail load.

The two following rules implement and augment the 1992 Act.

*1996 - Rule 888.* This rule furthers the nondiscriminatory open access requirement of the Energy Policy Act of 1992. It establishes a FERC-regulated tariff system to set pricing for transmission. The effect is to facilitate competition in the nascent power marketing industry.

*1996 - Rule 889 is also called OASIS (Open Access Same-time Information System rule).* The rule requires all parties to share information about available capacity of the transmission system on the Internet, thus facilitating real-time trading. Further, it prohibits self-dealing between a utility and its affiliates to ensure a competitive level playing field. These provisions set the stage for open access to the national wholesale electricity market.[1] Additionally, the rule orders separation of wholesale power marketing from transmission functions; this is not an order of divestiture or corporate re-organization but an order of functional unbundling. Industry has found the separation language to be unclear.

Industry generally complies with Rules 888 and 889. It is notable that a 1996 news release from FERC states that the rules cannot by themselves achieve an efficient, competitive electric industry. The news release points to both state and regional issues that need to be settled. One such issue is the question of where local distribution ends and interstate transmission begins; the rule states that local distribution remains in the hands of the local utility under the jurisdiction of the state but leaves it up to the state to place the dividing line between interstate transmission and local distribution based upon criteria set in Rule 888.

Bills introduced in Congress last session sought to shape state restructuring of the retail market. The bills proposed limitation on fees charged to departing customers (exit fees), set required retail access dates, and addressed various concerns regarding BPA and the Tennessee Valley Authority.

Other federal influences on restructuring are occurring in the courts. For example, one court case originating in New York and now pending in federal district court in Washington DC, questions who has jurisdiction over retail transmission. FERC asserts it does; the plaintiff states, including Washington State, disagree.

#### ii) Gas industry

The re-structuring of the wholesale gas market occurred earlier and with fewer ripples compared to the electricity industry. No federal statute directed the regulatory changes in the gas industry. The restructuring occurred through administrative orders relative to the common-carrier role of the interstate pipelines.

*1985 - FERC Order 436.* This Order affords incentives, not an order, for pipelines to offer gas transportation services to other gas providers. The Order fostered the beginning of bypasses, i.e. large industrial consumers of gas who build their own spurs from the pipeline and purchase gas directly from the pipeline.

*1987 - FERC Order 500.* The Order prohibits preferential treatment between pipelines and their marketing arms.

*1992 - FERC Order 636.* This ordered interstate pipelines to separate their transportation from the gas marketing functions and to provide open access (common carrier service) to all buyers of gas from all sources as well as the pipeline. This order succeeded in breaking up the pipelines' grip on the natural gas industry.

**b) The unsettled issue: Bonneville Power Administration**
BPA is both the marketer of electric power generated by federally-owned facilities and the controller of interstate and intrastate transmission of that power. Federal law, based on historical economic reasons, requires BPA to sell power at cost-based rates to certain preferential customers located in the Northwest; these are public (government) utilities, electric cooperatives, investor-owned utilities (but only for their residential and small-farm consumers), and direct service industries (mostly aluminum companies). Some eastern U.S. interests are opposed to the preferences received by the Northwest from BPA; legislation was introduced in Congress last session to require BPA to charge market rates rather than sell at cost.

In the year 2001 many of the contracts for purchase of BPA wholesale power expire. In 1995-1996, there was much concern that in the unregulated market of 2001, customers currently committed to purchase power at cost from BPA would find cheaper market-priced power elsewhere thereby leaving BPA insufficient income to meet its treasury obligations. More recently, however, changing market predictions suggest that BPA's rates will compare favorably to market rates and that BPA's traditional customers will be competing for shares of BPA's power. Nevertheless, the fear of an unstable BPA led to the formation of the Northwest Energy Review Transition Board composed of gubernatorial designees from Montana, Oregon, Washington, and Idaho. The Board concentrates on the following issues respective to BPA:

- cost control - so that BPA's cost price is competitive with market price
- fish and wildlife considerations - may result in reduced power generation and higher costs
- stranded costs - who pays?
- subscription - pricing and negotiations on new contracts
- transmission - separation of BPA's transmission from its marketing
- river governance

The Board seeks to foster a regional solution to these issues to present to Congress. If Congress goes ahead with national restructuring legislation, the region wants to be ready with a "Northwest" chapter to that legislation.

# III. Summary of non-tax related Washington legislation.

## a) Legislation passed this year.

*E2SHB 2831.* This Bill authorizes a study and requires electric utilities to unbundle the costs of their assets and operations. The legislation intends to force utilities to account for their cost structure. At a minimum the utility must separately account for generation and energy supply, delivery services, metering and billing, customer account services, conservation and renewable resource programs, general administration, overhead, and taxes. The study focuses on costs and service quality. Study data must be reported by investor-owned utilities to the UTC and by municipally-owned utilities to their own elected body and then to the State Auditor. Small utilities are exempted. By December of 1998, the UTC and State Auditor will submit a joint report to the legislature.

ESSB 6560. This bill authorizes a study and imposes certain consumer-protection duties upon utilities. Utilities must provide to consumers on a regular basis information about rates, metering policies, billing and payment options, disconnect requirements, and complaint procedures. The study, to be conducted jointly by the UTC and DCTED, focuses on retail rates and costs, demographics, cost-shifting, service territory agreements, reliability, and related retail/consumer issues. The study report is due to the legislature by December 31, 1998.

The Department of Revenue is not a participant in either study; however, the UTC invites Department staff to the study meetings and generally keeps staff apprised.

**b) Legislation proposed**
At the end of the 1998 legislative session, Senator Finkbeiner distributed to interested parties a preliminary draft of a bill restructuring the electrical industry under the portfolio model.[2] Key non-tax features of the bill are:

- ❖ Requires utilities to provide to consumers, classified by the size of their electricity usage, a choice of a retail package of service and energy supply (the portfolio);
- ❖ Allows for stranded costs to be recovered from consumers provided the costs are deemed prudent. Divestiture of assets is not required, however, the utility's governing body could so order.
- ❖ Requires out-of-state power suppliers to register with the UTC and allows the UTC to deny registration thereby prohibiting that supplier from entering into contracts with Washington businesses or consumers.
- ❖ Imposes public-purposes funding by the utilities for conservation, social, and environmental programs. The amount of money due from each utility is determined in a complex (but workable) manner by the Department of Revenue. The public purposes funding is not a tax.

## IV. Current taxation of the energy industry.

In Washington, gas distribution businesses and light and power businesses are subject to state and local excise taxes, property taxes, and in-lieu-of property taxes; in addition, consumers of gas pay a use tax. Each of these taxes are discussed below and comment made on the vulnerability of the tax both in the event of restructuring in Washington and in the current status of restructuring nationally.

## a) Property taxes

The property tax liability of utilities located in more than one county is determined by the Department through central assessment. Utilities situated in a single county are assessed by the county in which it is located. The chart below shows receipts for the thirteen light and power businesses and the four gas distribution businesses which are centrally assessed.

**Property Tax Paid By Centrally Assessed Light and Power Businesses**

| Year | Equalized Value Personal and Real | Avg. Rate | Tax |
|---|---|---|---|
| CY 1997 | $2,866,549,565 | $0.01352 | $38,755,750 |
| CY 1996 | 2,912,126,655 | 0.01393 | 40,565,924 |
| CY 1995 | 2,638,577,987 | 0.01382 | 36,465,148 |
| CY 1994 | 2,757,166,376 | 0.01353 | 37,304,461 |
| CY 1993 | 2,560,862,432 | 0.01344 | 34,417,991 |
| CY 1992 | 2,575,011,773 | 0.01336 | 34,402,157 |

**Property Tax Paid By Centrally Assessed Gas Distribution Businesses**

| Year | Equalized Value Personal and Real | Avg. Rate | Tax |
|---|---|---|---|
| CY 1997 | $1,051,367,794 | $0.01352 | $14,214,493 |
| CY 1996 | 969,260,176 | 0.01393 | 13,501,794 |
| CY 1995 | 843,633,039 | 0.01382 | 11,659,009 |
| CY 1994 | 875,500,139 | 0.01353 | 11,845,517 |
| CY 1993 | 735,400,183 | 0.01344 | 9,883,778 |
| CY 1992 | 682,541,402 | 0.01336 | 9,118,753 |

In many of the restructuring states, particularly eastern states, the property values of the utilities were artificially inflated either because the regulated utilities were a convenient tax base or because uneconomic capital investments (nuclear plants) were on the books at construction costs rather than value. In those states, when restructuring arrived and utilities sought to divest themselves of generation facilities at their true market value, local and state programs dependent upon property tax revenues were imperiled. In Washington, the values upon which the tax is based represents market value of tangible assets or net book value; we do not anticipate a significant threat to property tax revenues from restructuring in this state. On the other hand, as other states restructure and competition increases, light and power businesses in Washington may wish to sell off unprofitable generation plants. We cannot predict the tax consequences of such sales. For example, if a centrally assessed utility sells off a generation plant located within a single county as a stand-alone operation, that asset will then be locally assessed. The valuation will be influenced by the use to which the new owner puts the facility and land. In the alternative, the unprofitable plant could be purchased by another entity subject to central assessment. Each scenario presents a number of variables that could positively or negatively impact property tax revenues.

**b) Privilege or in-lieu-of property taxes**

The 25 public utility districts (PUD's) pay a privilege tax, often referred to as an in-lieu-of property tax, based on a combination of a percentage of gross revenues plus a rate times the number of kilowatt hours of power generated for retail and wholesale sales. Restructuring does not present a threat to the revenue from this tax. However, the tax statutes respective to PUD's are not structured to capture revenues from activities outside a vertically owned and operated system. For example, purchases and subsequent sale by a PUD of power generated from assets not owned or operated by the PUD do not come within the statutory provisions of the privilege tax.

**PUD Privilege Tax**

| | Distribution of State Tax | |
|---|---|---|
| Year | State | Local |
| FY 1997 | $12,540,274 | $15,253,653 |
| FY 1996 | 12,161,330 | 14,686,088 |
| FY 1995 | 11,815,000 | 14,303,000 |
| FY 1994 | 10,862,000 | 13,107,000 |
| FY 1993 | 10,041,000 | 12,240,000 |
| FY 1992 | 10,231,000 | 12,622,000 |

**c) Use tax on brokered natural gas**

In 1989, in response to the restructuring of the gas market, the legislature passed a use tax on brokered natural gas. The tax is at the same rate as the public utility tax on purchases of gas not already subject to tax. The intent of the legislation was to impose the tax on consumers who, by reason of restructuring in the gas industry, were able to purchase gas on the open market. In Washington, there are two such groups of customers, one group is called "bypass customers" and the other is called "transportation customers." Bypass customers are those who build their own spurs from the pipeline for direct delivery of gas. In Washington, we have seven bypass customers, two of which have an additional customer each for a total of nine consumers receiving gas outside the local distribution system. Transportation customers are those industrials, hospitals, schools, and large commercials who might have opted to bypass but instead, through UTC permission, were granted more favorable rates from the local distribution company for gas obtained on the wholesale market.

The use tax is designed to capture tax revenues from bypass and transportation customers that would otherwise be lost to the state because of purchase from out-of-state gas providers without nexus. Between bypass and transportation customers, 180 consumers pay the use tax on brokered natural gas. The chart below shows use tax revenues collected by the Department.

**Brokered Natural Gas**

*State Tax Rate .03852*

| Year | Collections |
|---|---:|
| FY 1997 | $8,712,000 |
| FY 1996 | 8,177,000 |
| FY 1995 | 7,938,000 |
| FY 1994 | 6,184,000 |
| FY 1993 | 4,219,000 |
| FY 1992 | 2,989,000 |

The use tax on brokered natural gas is under legal attack. Three suits filed in Superior Court challenge the constitutionality of the tax on the basis that it impermissibly burdens interstate commerce. However, at the end of September, 1998, opposing counsel in one of the suits informed our assistant attorney general that he will drop the action.

**d) Gross receipts taxes**

In the state of Washington, the public utility tax (PUT) is paid by investor-owned light and power business, municipal light and power business, public utility districts, gas sales and distribution businesses, and rural electric associations and cooperatives. While approximately 74 utilities pay the PUT on electricity and 20 businesses pay the PUT for gas distribution, ten businesses pay over 80% of the PUT revenues. In addition to PUT, the utilities pay B&O tax on certain activities such as services rendered for persons who are not yet customers of the utility.

The chart below shows PUT taxable gross receipts and tax revenues for all payers over the last six fiscal years.

**Public Utility Tax (PUT)**

| | Electricity | | Gas Distribution | |
|---|---|---|---|---|
| Year | Taxable | Taxdue | Taxable | Taxdue |
| FY 97 | $3,249,289,228 | $125,844,928 | $646,292,605 | $24,894,839 |
| FY 96 | 3,182,375,923 | 123,246,987 | 684,029,552 | 26,348,424 |
| FY 95 | 3,093,267,900 | 119,795,805 | 678,999,972 | 26,155,030 |
| FY 94 | 2,935,825,298 | 113,704,470 | 662,003,051 | 25,500,351 |
| FY 93 | 2,654,769,474 | 102,819,229 | 573,613,578 | 22,095,595 |
| FY 92 | 2,357,262,583 | 91,296,769 | 486,202,017 | 18,728,501 |

The gross receipts tax is vulnerable under various possible scenarios of restructuring. That vulnerability is discussed in the Section V below.

**e) Local taxation of utilities**

Local taxing districts receive property tax revenues from centrally and locally assessed utilities and from the PUD privilege in-lieu-of-property tax. In addition, some cities assert a gross receipts tax on utilities. In 1996, 5.62% of revenues paid to cities were attributable to this gross receipts tax. The measure of tax is the gross receipts of energy sales to customers or the gross receipts of an energy business located within the city.

# V. Tax policy in a restructuring environment.

Certain aspects of Washington's excise tax system are outdated and vulnerable in the face of federal restructuring of the wholesale market and the small but significant number of states restructuring their retail markets. The section below discusses the possible impacts to the excise tax system in the changing energy industry.

**a) The energy industry in a restructured environment**

Under restructuring, the energy industry is separable into three entities: local distribution, transmission, and power generation. If restructuring occurs in this state, Washington consumers may do business with three separate businesses rather than just one in obtaining their electricity. Each of the separate entities present distinct tax issues.

*Local distribution:* If Washington restructures its retail electricity market, the local distribution company (LDC), the keeper of the meter, will more than likely remain a regulated local monopoly as it has under gas restructuring. In general, the LDC is the convenient collector of a consumption tax and an identifiable, localized point for imposition of an excise tax. There are no legal barriers to asserting a state tax against LDC's.

While the LDC, for both gas and electricity, does not present significant potential for revenue loss either now or in the event of restructuring, certain tax issues will need to be addressed by the legislature. For example, under Senator Finkbeiner's proposal, approved stranded costs may be recovered over a 10-year period as transition charges passed on to consumers. Will the revenues from payment of these costs be taxable as PUT or B&O? Similarly, if the legislature provides for exit fees (charges made to customers who leave the LDC), the same question applies to the revenues from the fees.

*Transmission:* Transmission refers to the "carrying" of gas and electricity. Intrastate transmission is subject to the PUT; interstate transmission may not be taxed by the state. While transmission itself does not present significant tax policy issues, the legislature may wish to keep the cost of transmission in the tax base. That is, Washington consumers pay for interstate transmission, either through the rates paid to their local utility or, for consumers of brokered natural gas, through costs paid directly to the owner of the interstate transmission. Costs of transmission paid to the utility are subject to the PUT and the costs for interstate transmission directly paid by the consumer are included in the tax base for calculating the use tax on brokered natural gas. In the event Washington imposes a consumption tax on electricity, the legislature may wish to include a similar provision respective to electricity transmission.

*Power generation:* With or without Washington restructuring, in-state power generators may participate in the national wholesale and retail energy market. That participation together with out-of-state power generators possibly entering into Washington's markets presents significant challenges to Washington's tax system.

Under current law, when an in-state power generator exports power out of state, the export is not subject to the PUT or to B&O wholesaling. The table below shows reported exports of power or in other terms this is the amount of deduction taken on the Combined Excise Tax return for power sold out of state. The Department is not confident that these figures represent total exported power. It is likely that the light and power businesses deduct the exported power from gross receipts without showing such deduction on their combined excise tax return.

### Reported Exports Of Electricity

| Year | Count | Deduction Amount |
|---|---|---|
| CY 1991 | 0 | $ 0 |
| CY 1992 | 0 | 0 |
| CY 1993 | 4 | 63,477 |
| CY 1994 | 3 | 887,722 |
| CY 1995 | 2 | confidential* |
| CY 1996 | 3 | 54,276 |
| CY 1997 | 4 | 1,183,374 |

** State law does not allow disclosure of aggregated tax information for less than 3 taxpayers.*

Regardless of the possible infirmities of the figures, the trend is clear: Washington in-state power generators are exporting more power than they used to. Where does the sold power go? What if the power is sold to an out-of-state marketer who turns around and resells the power to an in-state consumer? The result is that electricity produced and consumed in Washington escapes taxation altogether. Such a scenario is possible although the Department does not know the extent to which it happens.

Some of the exported power is sold in the open retail market. For example, Seattle City Light sells power to Nordstrom in California. The sale of the power is not subject to Washington tax. The state does not lose revenue from this sale presuming that Seattle City Light is selling excess power. However, the possibility remains that net-importing or net-exporting of power eventually could result in loss of state revenues. If the cost of power is cheaper to purchase than it is to generate and sell (subject to the PUT), the utility may make the economic choice to purchase untaxed, cheaper power for its load and export produced power. Another twist on this possible scenario could occur under BPA's proposed allocation of its power. Pursuant to the proposed allocation, BPA will sell enough low-cost power to the investor-owned utilities to serve almost all of their residential/small-farm load. This would free up the utilities' more expensively produced and priced power for export. Under this possible scenario, the measure of the public utility tax is the low-cost BPA power rather than the higher-priced power.

If Washington restructures, power purchased by a retail customer from an out-of-state generator will not be subject to tax unless the generator has nexus. For example, a power generator in Montana could make a retail sale of power to any consumer in Washington. Absent nexus, the sale is not taxable. Not only would the state lose revenue but also an in-state power generator, whose price includes PUT, would lose a customer because its price is not competitive. Out-of-state power generators would have a competitive edge over in-state generators.

**b) New players in the energy business**

Open retail access gives rise to an active market where the hope of profit inspires entrepreneurial risk. This active market poses problematic taxation issues. Even without restructuring, three non-industry players: marketers, brokers, and investors, present tax policy questions.

*Marketers*. Marketers take "possession" (or title or ownership) of the gas or electricity. Rule 889 facilitated establishing this market on the internet. A marketer can sit at her desk in Montana and buy and sell electricity or gas all over the U.S. through her computer. Or, to put this another way, without establishing any presence for tax purposes in Washington, a power marketer can provide every bit of energy consumed in this state. Neither the marketer's income, nor the power imported, is subject to Washington tax. The amount of state revenues likely to be diverted in this arena cannot be measured, but the potential is significant.

Marketers located in-state raise their own tax issues. Since the in-state marketer is not a light and power business or a gas distribution business as defined in the public utility tax statutes, one of the B&O categories should be applicable to their gross receipts. Since gas is tangible personal property, the applicable B&O categories are wholesaling and retailing. On the other hand, electricity is not classified as tangible personal property; therefore, marketing of electricity falls into the service category. This may be perceived as unequal treatment for the two types of energy. At a minimum, it illustrates the point that the difference in property type between gas and electricity must be taken into account when considering tax alternatives.

*Brokers.* Brokers are distinguished from marketers in that brokers do not take possession of or title to the power. They serve the function of putting together buyers and sellers. Brokers, lacking a plant or system, are not subject to the public utility tax but are subject to the service B&O on the commissions they receive for putting together a sale if they have nexus. Because of the definitions in the PUT statues, Washington discourages in-state broker businesses. Brokers do not meet the definition of a "light and power business" or a "gas distribution business" for purposes of the PUT. While sales made by in-state light and power business or gas distribution business to another light and power business or gas distribution business are not taxable, such sales to brokers are. Then, when the broker sells the power, she is subject to B&O. Because the power they sell is subject to both PUT and B&O, in-state brokers claim they cannot compete with out-of-state brokers, thus leaving the Washington market open to out-of-state brokers or marketers.

*Investors.* Since the energy market functions similarly to the commodities market, investors are a component of restructuring. Investor buying and selling creates instability in prices.[3] With a tax system based on value such as Washington's, a volatile market makes it more difficult to accurately project state revenues.

**c) Nexus in the restructured environment**

As the above discussion shows, nexus is the most perplexing tax issue that accompanies restructuring. Since no court has yet ruled on nexus arising specifically out of restructuring, the issue is far from settled. As open access moves along, such a suit is inevitable. Policy makers note with interest a recent case out of Rhode Island in which the court found nexus for an out-of-state heating oil marketer by reason of the marketer's control of the product as it passed through interstate commerce and its contract with in-state deliverers. See Koch Fuels, Inc. v Clark, 676 A2d 330 (1996). Although tax practitioners often refer to Koch Fuels, to date, no court has relied upon or quoted the case.

**d) Special consumers, restructuring, and tax policy**

In Washington, two groups of consumers are direct beneficiaries of BPA preferences, the direct service industry and rural electric associations. Each presents unique issues for consideration.

*Direct Service Industries.* Thus far, the DSIs are not enthusiastic about restructuring. They have historically been dependent upon their ability to purchase power at the most economic price possible to keep their electricity-intensive operations viable. The eleven DSI's in Washington already purchase electricity in an open market. These purchases generally are not subject to state taxation, either because the purchase is from BPA or because the purchase is from an out-of-state supplier without nexus. Only if a DSI elects to purchase from an in-state utility is the sale subject to the utility tax. Historically, DSIs have purchased much of their power from BPA, but their reliance on BPA power has diminished, and will diminish further if BPA implements its proposed allocation of power for the 2001 - 2006 period. DSIs are not required to make reports to the Department regarding their electricity purchases, so their expenditures for electricity are unknown. However, the aluminum industry provided the following data showing their combined consumption of electricity measured in dollars.

**Power Consumption By The Aluminum Industry**

| Dollars in Millions | |
|---|---|
| CY 1996 | $393.3 |
| CY 1995 | $372.6 |
| CY 1994 | $357.2 |
| CY 1993 | $341.8 |

In the past, some DSIs have said imposition of a tax on electricity would make their cost of operations too high thereby jeopardizing continued operation in this state.

*Rural electric associations.* The rural electric association (REA) is another group unenthusiastic about restructuring. This group, similar to the DSIs, already participates in the wholesale market through purchase of power from BPA or out-of-state marketers. Subsequent sale of that power is subject the PUT. The tax changes that accompany restructuring may negatively impact REAs, especially if those changes impose a consumption tax. A value-based consumption tax is particularly unwelcome to the state's eight REAs because their rates are approximately 36% higher than the rest of the state.

**e) Other states' response to electricity restructuring**

Eleven states restructured their retail electricity markets either through legislation or through orders issued by their utilities commission. Of the eleven, California and Massachusetts have ballot initiatives pending to repeal or modify the re-structuring; New Hampshire's restructuring is delayed pending litigation over the provisions for recovery of stranded costs. The restructuring legislation of two other states, Montana and Pennsylvania, survived recent administrative appeals and are slowly going forward.

The tax provisions of the restructuring states are not necessarily instructive for Washington for two reasons. First, the hot issue in many states is the negative impact to property tax revenues with the divestiture of assets that were over-valued on the tax rolls. This is not perceived to be an issue in Washington. Second, states with a utilities gross receipts tax (UGRT) also generally have a corporate business tax. Consequently, when restructuring, the UGRT is repealed and easily replaced with a corporate business tax. Such an alternative is not possible in Washington. Further, some states, such as California and Montana, made no changes to their taxing scheme.

However, the tax provisions of some restructuring states are instructive. In Pennsylvania, rather than repeal the UGRT, the legislation strengthened it by redefining the definition of gross receipts to include out-of-state power suppliers. This is accomplished by saying a sale of electricity occurs within the state if the meter of the customer is located within the state. Meter-equaling-nexus is only one of the provisions in the bill designed to create nexus; the other provision requires out-of-state suppliers to register with the public utilities commission. The commission has the authority to revoke a registration for failure to pay the UGRT. To further avoid erosion of state revenues, the bill allows for a surcharge to be attached to the UGRT in the event revenues fall below a specified amount through the year 2004 and a use tax is imposed on in-state companies for power purchased from out-of-state, non-nexus companies. Pennsylvania's legislation, passed at the end of 1996, orders pilot programs only in 1997 and 1998; retail access is not proscribed until 1999 and then for only 66% of the market. The statutorily-imposed nexus has yet to stand the test of time. A recent telephone conversation with counsel for the Pennsylvania Department of Revenue revealed that each day that passes without notice of a lawsuit surprises the legal department.

Illinois imposed a consumption tax on users of electricity. The volume-based tax is assessed upon kilowatts consumed at rates descending as usage increases. The tax will be collected by the local distribution company. The legislation allows commercial and industrial consumers to "self-assess" and pay on the cost of electricity purchased rather than the kilowatts consumed provided the taxpayer complies with certain registration requirements. The governor has not yet signed this portion of the legislation and the "self-assessment" process will probably not be implemented in time for the August 1, 1998, effective date.

New Jersey provides an interesting case. Rather than a restructuring bill, the legislature passed an Energy Tax Reform bill effective January l, 1998. The bill repeals both the UGRT and the franchise tax on gas and electricity and imposes a sales and use tax. Federal installations are the only significant exemption from the new tax. The tax treatment presumes electricity and gas both to be tangible personal property. According to a contact at the New Jersey Department of Revenue, the legislation received little publication and has not generated any taxpayer protest. This is attributed to the fact that not only does the consumer see little net change to total energy costs, the law allowed the new tax to not be reflected on the bill to consumers.

A recent report lists Kansas as currently considering a legislative tax change in anticipation of restructuring.

# VI. Taxation alternatives.

### a) Legislation proposed during the last two sessions

*DOR 1997 bill.* Operates much the same as the use tax on brokered natural gas. The proposed legislation imposes a use tax on the consumption of electrical energy to the extent that the PUT has not been paid on the value of the electrical energy consumed. The DSI's floated an amendment to the Department bill that exempted them from this tax.

*Representative Thomas' bill.* Asserts a state and local consumption tax on gas, electricity, and telecommunications and repeals state and local PUT and the use tax on brokered natural gas. Imposes B&O at retailing and wholesaling rates as applicable and service rate for wheeling. The bill specifies that electricity is not tangible personal property.

*DSI/Aluminum industry bi*ll. Asserts a retail and use tax on electricity but exempts from that tax the aluminum industry, DSI, deep-well irrigators, and anyone who gets power from BPA. While the bill does not eliminate the PUT, it eliminates from the definition of gross receipts subject to PUT the amounts received for electricity and wheeling.

*Senator's Finkbeiner's proposal.* Similar to the DSI/Alum's proposal.

Flat tax on consumption of electricity (PSE's 1997 strawman). Imposes a per kilowatt-hour tax on the consumption of electricity and repeals the state and local PUT. Allows the locals to impose a per kilowatt tax. Changes the definition of manufacturer to include electric companies.

### b) The great debate: consumption tax versus a gross receipts tax

If the Washington legislature should decide to move forward with a new tax scheme for the energy business, the choice may boil down to a policy choice between a consumption tax or a gross receipts tax (similar to the current public utility tax or a variation on a B&O tax) strengthened to address nexus. A consumption tax could be based on either the value paid for the energy or on the volume (kilowatt and cubic feet) consumed.

*The advantages of a consumption tax are as follows:*

- ❖ avoids problems with nexus
- ❖ can be efficiently and easily administered with the regulated local distribution company as the tax collector [4]
- ❖ offers flexibility for local option city and county taxation
- ❖ may promote energy conservation
- ❖ in-state power producers would have less of a competitive disadvantage when competing with out-of-state power producers who, lacking nexus, do not have to pay and then recoup the PUT in their sales price

*The disadvantages of a consumption tax are as follows:*

- ❖ adds to the regressivity of Washington's already regressive tax system by reason of the consumption-based sales tax
- ❖ in some cases, establishing the point of sale may be difficult for industry as the location of the meter and the billing address are not necessarily the same
- ❖ those consumers who located in Washington because of low energy prices or BPA preferences will feel disadvantaged unless the consumption tax accommodates their high-volume use
- ❖ if the consumption tax is value-based, it places an additional tax burden on those who pay a comparatively high price for power such as REA's

*The advantages of a strengthened gross receipts tax are as follows:*

- ❖ it is consistent with Washington's current tax system
- ❖ businesses are used to the gross receipts tax and do not need to make adjustments to their accounting systems to accommodate the tax
- ❖ it places no additional administrative burden on the state
- ❖ cities could maintain revenues

*The disadvantages of a strengthened gross receipts tax are as follows:*

- ❖ even if strengthened similarly to Pennsylvania's gross receipts tax, nexus may still be subject to legal challenges thereby putting revenues at risk
- ❖ the electricity sold to and consumed by direct service industries remains untaxed unless a strengthened gross receipts tax also includes a use tax on brokered electricity

**c) other tax alternative**

As an alternative, the state may wish to consider a combination value-based and volume based tax similar to the tax enacted by Illinois but adapted to Washington's gross receipts tax scheme. The PUT or B&O would continue to be imposed where applicable; an indexed kilowatt per hour tax would be imposed on consumers. With a volume-based tax, the consumer would not be impacted by fluctuations in the price of power and the revenues would be predictable. Large industrials and DSI's could opt for an indexed value-based or volume-based tax. The purpose of the option would be to help these industries remain competitive and at the same time share in the obligation to pay taxes.

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# Endnotes for Appendix 4.1

[1] There are over 400 FERC-regulated wholesale power marketers.

[2] There is no indication that the Senator intends to submit this bill to the legislature.

[3] In late June a power trading company defaulted on several large contracts to supply power to eastern states. Not only could the company not provide the electricity at the agreed upon price, it could not even provide the electricity at an economically viable price. The company blames, in part, the aggressive trading by investors for its inability to purchase electricity at a reasonable cost.

[4] If the consumption tax is value-based rather than volume based, the ease of administration may be somewhat complicated because a power supplier who is unaffiliated with the local distribution company may want to keep the selling price confidential between the consumer and the supplier.